Testimony

of Franklin J. Vargo
Vice President, International Economic Affairs
National Association of Manufacturers

on behalf of the National Association of Manufacturers

before the Subcommittee on Commerce, Trade, and Consumer Protection of the House Energy and Commerce Committee

On "Dominican Republic-Central America Free Trade Agreement"

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Mr. Chairman and Members of the Subcommittee:

I am pleased to testify today on behalf of the National Association of Manufacturers (NAM) to provide a perspective on the U.S.-Central America- Dominican Republic and Free Trade Agreement (CAFTA-DR). The National Association of Manufacturers is the nation's largest industrial trade association, representing small and large manufacturers in every industrial sector and in all 50 states. Headquartered in Washington, D.C., the NAM has 10 additional offices across the country. All of our members are affected directly or indirectly by trade and have a keen interest in the factors affecting our trade and international economic relations.

The U.S. -Central America-Dominican Republic Free Trade Agreement (CAFTA-DR) is unambiguously a winner for U.S. manufacturing. The NAM strongly supports this comprehensive agreement. It levels the playing field for U.S. producers by providing the same access to DR-CAFTA markets that their producers enjoy in the U.S. market.

Under CAFTA-DR, U.S. manufactured goods exports will become duty-free (80% as soon as the agreement goes into effect), while European and other competitors will continue to face CAFTA-DR's tariffs and other trade barriers. As a direct result, U.S. manufacturers stand to gain $1 billion of additional manufactured goods exports, with approximately 12,000 related job opportunities for American workers, according to an analysis by the NAM.

More significantly, CAFTA-DR could preserve up to four times that amount of existing U.S. exports. Without the agreement, CAFTA-DR countries are at severe risk of losing their $10 billion of apparel exports to the United States to Asian competitors, and would have to cut their global imports by $10 billion – over 40% of which would be lost U.S. exports worth $4 billion, affecting 48,000 U.S. jobs.

The agreement also strengthens the ability of U.S. and Central American producers to compete against China and other Asian competitors. If the CAFTA-DR countries lost their apparel industry to Asian producers, 550,000 people could be put out of work in the region. Loss of their apparel exports to the United States would cause the region's GDP to fall about 7 percent, putting their economies into serious recession and slashing U.S. exports to the region.

Currently, 80% of U.S. imports from CAFTA-DR are duty-free – due to the one-way market access programs already provided to them; moreover, excluding textiles, 93% of U.S. manufactured goods imports from CAFTA-DR already are duty-free.

While the agreement has significant potential to maintain existing CAFTA-DR exports to the United States, it is unlikely to generate significant new net manufactured goods imports into the United States. This is because the CAFTA countries already have open access to the U.S. market for almost all manufactured goods. Moreover, the six

CAFTA countries together have an economy of only $77 billion. That makes their combined economy about the size of Sacramento, California!

The CAFTA-DR Free Trade Agreement

The U.S. – Central American – Dominican Republic Free Trade Agreement (CAFTA-DR) would increase trade among the United States and Costa Rica, the Dominican Republic, El Salvador, Guatemala, Honduras, and Nicaragua. The free trade agreement (FTA) will eliminate tariffs to agricultural and manufactured goods, and would improve the rules governing trade – such as by strengthening intellectual property protection, increasing safeguards against product counterfeiting and copyright piracy, strengthening investment rules, opening access to government procurement, facilitating electronic commerce, speeding customs processing, encouraging express delivery, and opening financial, telecommunications and other services markets.

It is important to stress the comprehensive nature of the agreement's coverage, and also its very strong and positive contributions toward improving both labor and environmental conditions in the CAFTA-DR region.

The CAFTA-DR countries already enjoy almost completely open access to the U.S. market, but maintain significant barriers to U.S. exports. The agreement would level the playing field for U.S. producers by providing the open access to the CAFTA-DR countries that they already have in the U.S. market because of the one-way market access programs provided to them by the United States in earlier years. The agreement would benefit the CAFTA-DR countries by making their access to the U.S. market permanent and by bolstering the region's ability to compete against Asian producers.

U.S. Manufactured Goods Trade with CAFTA-DR

The CAFTA-DR region imported $15.7 billion of U.S. goods in 2004, as shown in Table 1., making it the 13th largest export market for the United States. In the Western Hemisphere the CAFTA-DR market is second only to Mexico as a market for U.S. exports. It is a larger market for the United States than Brazil, even though Brazil's economy is considerably larger than the combined economies of the CAFTA-DR countries.

Manufactured goods predominate U.S. trade with the CAFTA-DR countries. Fully 87 percent of U.S. exports and 83 percent of U.S. imports are manufactured goods. Textiles and apparel are the largest category of goods traded, accounting for about 55 percent of U.S. imports and over one-fourth of U.S. exports. U.S. textile exports consist principally of fabric and other textiles that are inputs into CAFTA-DR apparel production that is exported back to the United States under existing preference programs. CAFTA-DR accounts for nearly 30 percent of U.S. textile exports to the world.

U.S. manufactured goods trade with the CAFTA-DR countries typically runs a small deficit overall, but a large and growing surplus in non-textile/apparel areas, as is shown in Table 1. Last year's manufactured goods deficit was $1.1 billion, comprised of a $5.4 billion deficit in textiles and apparel trade and a $4.3 billion surplus in all other manufactured goods trade. Paper and paper products, chemicals, motor vehicles and other transportation equipment, machinery, and electrical equipment and appliances are significant U.S. manufactured goods exports to the region.

Table 1.

U.S. Merchandise Trade with CAFTA-DR, 2004
Millions of Dollars

	Exports	Imports	Balance
Total	$15,731	$17,663	-$1,932
Manufactured Goods	$13,628	$14,719	-$1,091
Textiles and Apparel	$4,244	$9,679	-$5,435
Other Manufactured Goods	$9,384	$5,040	$4,344
Other Goods	$2,103	$2,944	-$841

Source: U.S. Census Bureau Trade Statistics

The United States is region's major trading partner. Using trade statistics of the six countries as compiled by the International Monetary Fund (IMF), the U.S. share of CAFTA-DR's global imports was 41 percent.

Table 2.

CAFTA-DR Imports from the World and U.S., 2003

	2003 Total Imports from World, $ millions	2003 CAFTA-DR Imports from the U.S., $ millions	U.S. Import Market Share, %
CAFTA-DR total	36,627	14,968	41%
Costa Rica	7,663	1,775	23%
Dominican Republic	8,082	4,214	52%
El Salvador	5,763	2,881	50%
Guatemala	7,339	2,501	34%
Honduras	5,894	3,129	53%
Nicaragua	1,887	469	25%

Source: International Monetary Fund.

The United States is also the CAFTA-DR region's largest customer. IMF data show that in 2003 the CAFTA-DR countries exported $24.6 billion to the world. U.S. imports from the region that year were $16.9 billion, nearly 70 percent of the CAFTA-

DR countries' global exports. By far their most important export is their shipments of apparel to the United States, which in themselves comprise 40 percent of the region's total exports of all products to the world.

How The CAFTA-DR Agreement Will Effect U.S. Exports

The CAFTA-DR free trade agreement has the potential to have a significant effect on U.S. exports. There will be three types of effects: (1) expansion of U.S. exports stemming from the reduction and elimination of CAFTA-DR tariffs on U.S. production; (2) expansion of U.S. exports through the reduction of non-tariff barriers in the CAFTA-DR countries and the trade facilitation measures they are committed to take; and (3) preservation of existing U.S. exports that would otherwise be lost if CAFTA-DR garment production shifted to China or other Asian nations.

Together, these three effects could total to as much as $5 billion. The tariff effect would be roughly $1 billion. Non-tariff effects are important and positive, but difficult to quantify. By far the largest of the effects would be the preservation of existing U.S. exports that would be saved by reducing or preventing the loss of CAFTA-DR production to China and other Asian nations, a loss that would result in a sharp reduction in the amount of goods the CAFTA-DR region buys from the United States.

Tariff Effects

Producers in the CAFTA-DR region already have very open access to the U.S. market, while U.S. producers face significant trade barriers in attempting to sell into their markets. Thus the agreement can be expected to have a stronger expansion effect on U.S. exports than on U.S. imports. U.S. manufactured goods exports to the CAFTA-DR region face tariffs that, on a weighted average by major product groups, are generally in the 4 to 10 percent range, as is shown in Table 3. These tariff averages reflect both very low tariffs but also tariffs that are in the range of 15-20 percent or even higher.

In examining the likely effects of tariff elimination, the NAM utilized an econometric trade substitution model. This model was applied to all U.S. manufactured goods exports other than textiles and apparel. Because of the inter-relationship between CAFTA-DR garment production and the inter-related requirement for the use of U.S. fabrics and other inputs, an econometric model would not yield meaningful results. The NAM's estimates of manufactured goods export gain are thus net of the textiles and apparel sector.

It should be noted, however, that the U.S International Trade Commission's (USITC) analysis indicated the agreement would boost U.S. textile and apparel exports by $700 million, and U.S. textile and apparel imports by $680 million – essentially expecting a neutral effect on these industries.

The NAM analysis takes consideration of the substitutability of U.S. exports that might displace existing domestic production in the CAFTA-DR countries, and U.S. exports that would displace third-country exports to the region. An examination of the industrial production structure of CAFTA-DR manufacturing industry and the composition of U.S. exports showed very little overlap or substitutability. The vast bulk of U.S exports to the region are products that are not made in the CAFTA-DR region.

There is, however, a high degree of similarity in the composition of U.S. exports to CAFTA-DR and other country exports to the region, and this is where almost all of the tariff effect will take place on U.S. exports. U.S. exports to the region will become duty-free, while exports from the European Union, Canada, Japan, and other countries will continue to be subject to the full duties of the CAFTA-DR countries. This will make U.S. products more price-competitive relative to third-country production and will result in a shift of CAFTA-DR purchases from the other suppliers to U.S. products.

The results of the NAM tariff effects model are shown in Table 3, below. The elimination of tariffs on U.S. exports of manufactured goods (leaving aside textiles and apparel, as explained above, is estimated to generate over $1 billion in additional U.S. manufactured goods exports. Miscellaneous manufactures, electrical equipment, chemicals and allied products, and paper products would be the largest dollar gainers.

Table 3.
U.S. Export Gains from CAFTA-DR Tariff Elimination

	U.S. Exports, $ Millions	Applied CAFTA-DR tariff, %	Gain from tariff elimination, $ millions	Percentage Gain, %
Paper and wood products	757	10%	141	19%
Tires and other rubber products	212	10%	43	20%
Metals	247	6%	40	16%
Chemicals, including photography supplies	1,431	5%	159	11%
Motor vehicle and parts	*449*	11%	112	25%
Transportation & Equipment	182	4%	13	7%
Non-electric machinery	1,281	4%	104	8%
Electric Machinery	2,597	4%	176	7%
Mineral Products	980	4%	60	6%
Manufactured articles not specified elsewhere	1,248	7%	203	16%
Total, excluding textile and apparel	9,382		1,051	11%

See Methodology section for sources and other information.

These exports would not displace local production in the CAFTA-DR countries, but would instead displace imports into the region from producers in countries that would still be subject to the full import duties assessed by the CAFTA-DR countries. The model's estimates are for export gains after all tariffs are eliminated. As not all CAFTA-DR tariffs on manufactured goods would be eliminated immediately, the above estimates are not a first-year result. Additionally, it is important to note that these estimates are incremental to the base of U.S. exports – i.e., the model is not estimating an absolute level of exports, but instead is estimating how much larger exports would be with the tariff cuts than without them. The overall level of U.S. exports, of course, depends on many factors, particularly the health of the CAFTA-DR economies.

Bound vs. Applied Rates

A very important aspect of the agreement has been widely overlooked by most observers – the fact that the official tariff bindings – so-called "bound tariff rates" of the CAFTA-DR countries are much higher than the statutory tariff rates they actually apply. This is not uncommon for developing countries, many of whom have unilaterally reduced the tariff rates they actually charge, while keeping their bound rates at high levels.

Table 4.
CAFTA-DR: Bound Tariff Rates

	Bound Tariff Rate
Costa Rica	44%
Dominican Republic	35%
El Salvador	35%
Guatemala	41%
Honduras	32%
Nicaragua	41%

Source: World Trade Organization. Bound tariff data are unweighted averages.

The significance of this is a country may legally, under WTO rules, charge any tariff rate it wishes, so long as it does not exceed its bound rate. Thus, if any of the CAFTA-DR countries wished, they could raise their tariffs up to the extremely high levels that are summarized in Table 4. As these are averages, some bound rates will be even higher. For example, CAFTA-DR bound tariffs can be as high 50 percent on transportation equipment. Without the CAFTA-DR agreement, U.S. exporters would have no recourse against countries' raising their applied tariffs. The CAFTA-DR agreement, however, would commit these countries to maintain zero duties on U.S. products even if they hiked their applied tariff rates up to their bound tariff levels.

In such a case, other exporters to the CAFTA-DR countries would have to pay the higher tariffs, while U.S. exporters continued to have duty-free access. This guarantee is of substantial value. U.S. bound and applied rates are virtually identical, as is typically the case for industrial countries, so there is no U.S. obligation here.

Non-Tariff Effects

The second effect on U.S. exports stems from liberalization of non-tariff barriers and improvements in trade-facilitating rules and policies. These include express delivery, customs clearance, intellectual property protection gains, etc. For example, the agreement requires that customs processing be accelerated and imported goods be able to clear customs within 48 hours to the extent possible. Advance customs rulings, transparent publication of customs rules, and other trade facilitation steps will lower the cost of processing exports.

The technical barriers to trade provisions are expected to reduce arbitrary rulings on standards. The agreement increases the likelihood that U.S. standards and conformity assessment procedures will be more broadly accepted, which will reduce costs in the chemicals, machinery, and other areas. Smaller U.S. exporters will benefit disproportionately. Additionally, the agreement improves the ability of U.S. exporters to switch distributorships, which is presently difficult to do in some of the countries.

These improvements will result in expanded exports, but there is no economic model to estimate the amount of the gain. After consultation with knowledgeable NAM members, we believe these gains may be equivalent to a further 5 percent reduction in the total cost of providing exports into the CAFTA-DR markets. While the effects are real, and in some instances may rival the size of the tariff effects, there is no reliable way of quantifying the non-tariff benefits.

Export Preservation

By far the largest effect on U.S. exports would be the preservation of some or all of existing U.S. exports to the CAFTA-DR countries that otherwise would be lost if Asian countries displaced current CAFTA-DR country apparel exports to the United States. This effect could be as large as $4 billion of U.S. exports.

As the CAFTA-DR countries do not have large currency reserves or borrowing capacity, the amount they can buy from the United States and other countries depends on how much foreign currency they can earn.

The region has four significant sources of foreign exchange -- exports of goods, remittances from workers who have migrated to the United States, tourism earnings, and investment inflows. If CAFTA-DR country exports of apparel to the United States were to be displaced by Asian-made apparel, none of the other three sources would automatically increase to make up for the loss of export earnings.

Thus, for every dollar of apparel exports the CAFTA-DR countries lose to Asian competitors, they will have to cut their imports by a dollar. If they were to lose all $10 billion of apparel exports they currently sell to the United States, they would have to cut their global imports by $10 billion. Since over 40 percent of what they import comes from the United States, it is obvious this is a matter of some consequence to U.S. exports.

Most observers believe that in the absence of the CAFTA-DR agreement, the region risks losing all or most of its apparel industry. The cause of this loss is the January 1, 2005, expiration of the global textile quotas that had been permitted by World Trade Organization (WTO) rules. Analyses by the International Monetary Fund, the World Bank, and others indicate China's costs are lower than all other producers and in the absence of quota restraint would be able to put most producers, including those in the CAFTA-DR region out of business. Even analyses performed by such anti- trade agreement organizations as the Global Trade Watch state that without the CAFTA-DR agreement, the region's apparel production cannot survive.

The U.S. International Trade Commission's (USITC) analysis of the CAFTA-DR agreement indicates that implementation of the CAFTA-DR agreement will provide enough added advantages to enable the region's producers to maintain their exports to the United States and avoid the loss of its industry. The USITC does not foresee a significant net increase in imports into the United States resulting from the CAFTA-DR agreement, and states that any increase in the region's exports to the U.S. market likely would be in lieu of other imports into the United States. In fact, as noted earlier, the USITC analysis sees a small ($20 million) positive net export effect in this sector.

Thus, if without the benefit of the CAFTA-DR agreement' preferences, CAFTA-DR producers were unable to compete with Chinese producers and lost their entire U.S. market, their exports to the United States would fall by $10 billion. As earlier noted, the United States has more than a 40 percent share of their imports, so our exports to them would be expected to fall by about $4 billion.

There would not be an offsetting increase in U.S. exports to China. This is because while the CAFTA-DR nations spend virtually everything they earn, China does not. Rather than utilizing its U.S. dollar earnings to purchase U.S. goods or services, China instead uses them to build up its foreign currency reserves to keep its currency undervalued and implement its export-led growth policy. In 2004, for example, China added to its currency reserves by $200 billion, even while it earned a $162 billion merchandise trade surplus with the United States. China now has currency reserves of $600 billion, 40 percent of its entire annual production of goods and services.

The NAM's calculations for the relationship between exports and U.S. employment indicate that currently about 12,000 jobs are associated with every $1 billion of exports, as was noted earlier – meaning that if there were a $4 billion drop in U.S. exports, about 48,000 U.S. job opportunities would be eliminated. Many would probably be in the U.S. textile industry, since the CAFTA-DR region is one of the only large purchasers of U.S. textiles – which they must use to obtain most of their tariff preference privileges. Losses, however, would also occur in other sectors as well.

It should be stressed that the NAM is not making any forecast of its own with respect to the degree to which the CAFTA-DR countries can preserve their sales to the United States under the CAFTA-DR agreement. For purposes of the analysis, the NAM relied on the USITC's estimates of the effect of the agreement on the region's garment industry. The NAM also accepts, at the other end, the widely-held view that without the agreement, their apparel industry has little, if any, hope for survival.

Thus the maximum effect on preserving U.S. exports is calculated by the difference between the CAFTA-DR producers being able to keep their present $10 billion in annual apparel exports to the United States or entirely losing their markets to Asian – and particularly Chinese – producers. Certainly the CAFTA-DR agreement is the best hope for the region's producers. If, however, the agreement were not sufficient to enable them to maintain their sales, then of course, the figures for the preservation of U.S. exports would be proportionately smaller. For example, if only half their sales were preserved, then the differential effect on U.S. exports would be half the maximum depicted in this paper.

Economic Effects on CAFTA-DR Countries of Losing Apparel Exports

As part of the analysis, the NAM considered some of the domestic economic effects in the CAFTA-DR region if they were to lose their apparel industry to China or other Asian nations. Even a cursory look shows that the effects on their economies would be severe.

The NAM's analysis shows that there are about 550,000 people working in Central America's apparel industries. Were the industry to see its exports to the United States displaced by Asian producers, most – if not all – of these jobs, which are among the highest-paying in the region, would disappear. As shown in Table 5, the job losses would raise the overall official unemployment rate in the region to 17 percent.

The actual job losses would be higher if the apparel industry disappeared, for support jobs in other industries – e.g., transportation services – would disappear as well. Additional jobs would be lost in the service and other industries as the former apparel workers no longer had income with which to purchase goods and services. The NAM has no estimate for the size of this "multiplier" effect in the CAFTA-DR countries, but by way of order of magnitude, if the multiplier were the same as in the United States, an additional 275 thousand workers would become unemployed, increasing the region's unemployment by over 800,000 and implying an unemployment rate of 18 percent.

Table 5.
CAFTA-DR Unemployment, Assuming Loss of Textile/Apparel Industry

	Current Unemployment, thousands	Unemployment Rate, %	Textile/Apparel Employment, thousands	Prospective Unemployment, thousands	Prospective Unemployment Rate, %
CAFTA-DR	2,063	14%	549	2,612	17%
Costa Rica	118	7%	45	163	9%
Dominican Republic	404	17%	138	541.5	22%
El Salvador	170	7%	91	261	10%
Guatemala	288	8%	122	410	11%
Honduras	663	28%	107	770	32%
Nicaragua	420	22%	46	466	24%

Sources: Overall employment data from CIA World Factbook, for 2003. Textile/apparel employment data are latest available, from USITC country studies.

Moreover, CAFTA-DR's apparel exports account for a surprisingly large portion of the region's entire Gross Domestic Product (GDP). Their net exports of apparel to the United States of about $5.5 billion are equivalent to 7 percent of their combined $77 billion GDP – the sum total value of all goods and services produced in the region.

A 7 percent drop in GDP would put the region into a serious recession. Such a decline would be two and a half times as large as the deepest recession the United States has had in the last 50 years (1982's 2.6 percent drop). The political stability consequences in the CAFTA-DR countries of having 550 thousand or more people become unemployed and enduring a 7 percent decline in GDP with little prospect of recovery are self-evident.

Table 6.
CAFTA-DR Gross Domestic Product, 2003
(Billions of U.S. Dollars)

Total	**$77**
Costa Rica	$18
Dominican Republic	$16
El Salvador	$13
Guatemala	$20
Honduras	$7
Nicaragua	$4

Source: International Monetary Fund

The CAFTA-DR countries are already highly dependent on remittances. For example, in El Salvador remittances are 15% of its GDP. An Inter-American Dialogue report found that the CAFTA-DR countries received $9 billion in remittances in 2003. While this counter-cyclical flow would surely rise in the event of massive layoffs in the CAFTA-DR region, the present numbers indicate that migrants are already hard-pressed and increases are likely to be small.

Effect on U.S. Imports

Turning to U.S. imports, the analysis indicates the CAFTA-DR agreement is unlikely to generate significant new imports to the United States. The primary reason for this assessment is that the CAFTA-DR countries have been enjoying preferential access to the U.S. market under a variety of special programs such as the Caribbean Basin Trade Partnership Act (CBTPA).

Fully 80 percent of their exports to the United States already enter duty-free under these programs. Moreover, outside the textiles and apparel industries, 95 percent of CAFTA-DR exports already enter the U.S. market duty-free. Thus they will obtain little new U.S. market access. The key benefits to the region lies in the greater ability to withstand Chinese and other Asian nation competition in the apparel area, and the fact that their access to the U.S. market will be permanent and not dependent upon possible changes in U.S. legislation or policies.

Table 7.
Proportion of U.S. Imports from CAFTA-DR Currently Entering Duty-Free, %

All Imports	80%
Manufactured Goods	77%
Textiles and Apparel	68%
Other manufactured goods	95%

Source: United States International Trade Commission

Certainly the improved investment rules, better rule of law, greater protection of intellectual property, better-functioning services markets, and other structural improvements that the countries will make under the agreement are likely to improve their business and labor climate and have a positive effect on U.S. and other investment in Central America.

However, fears that a flood of U.S. investment will pour into the CAFTA-DR region and "outsource" U.S. jobs are unfounded. First, it is important to understand that at the present time there are no restrictions on U.S. investment into the region. American companies have been free to invest.

Second, three of the countries already have Bilateral Investment Treaties (BITs) with the United States that provide U.S. investors with substantially the same benefits as the FTA would.

Third, it is important to understand just how small the CAFTA-DR economies are. Together their production of goods and services (total GDP) is only $77 billion. This is a tiny fraction of U.S. production. To be precise, their combined GDP is seven-tenths of one percent (0.7 percent) of U.S. GDP or the size of Sacramento, California. Even investments significant to their economies would be small in scale to present trade flows.

Finally, any increased investment in the CAFTA-DR region is most likely to be in product areas that would otherwise see imports into the United States from Chinese or Asian production – rather than displacing U.S. production. As noted earlier in this analysis, U.S. imports from the CAFTA-DR region would result in greater U.S. exports than if the production were in Asia.

Thank you again Mr. Chairman and Members of the Subcommittee. I appreciate the opportunity to express my views, and those of the National Association of Manufacturers about the importance of CAFTA-DR.